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TAGS: ECON ETRD EINV EFIN PREL IN SN
SUBJECT: SINGAPORE PERSPECTIVES ON INDONESIA'S ECONOMIC OUTLOOK

REF: WILLETT-HALL EMAILS 9/30

¶1. (U) Summary: Singapore-based financial analysts believe that Indonesia's economic problems are not a harbinger of another Asian financial crisis, and that the risk of contagion is small given Indonesia's much stronger fundamentals compared to 1997-98. Although generally optimistic about Indonesia's growth prospects through 2006, the analysts remained skeptical that Jakarta would correct its inappropriately loose monetary policy. Indonesia, they said, would move to reduce fuel subsidies, but needed also to move on what they saw as the real problem -- rapid growth of the money supply. End summary.

¶2. (U) We met with Singapore-based financial analysts Claudio Piron (JP Morgan Chase), Ray Farris (Credit Suisse-First Boston), and Euben Paracuelles (DBS Bank) on September 22. Piron expressed confidence that President Yudhoyono would be successful in removing Indonesia's controversial fuel subsidies over the next several months. Financial analysts' estimates on how large the first cut in October would be range from 30 percent to 50 percent, but the exact number would be less important than the signal Jakarta would send by taking action, Piron said. A subsidy cut in this range would send an important sign to investors that Jakarta was serious about taking the tough steps necessary to get the economy back on track.

¶3. (SBU) Ray Farris of Credit Suisse First Boston agreed that Jakarta seemed poised to tackle the fuel subsidies issue. He argued, however, that the government's focus on the fuel subsidies shifted attention from the real problem, one it is not prepared to address -- Bank Indonesia's overly loose monetary policy. The rupiah, he pointed out, did not suddenly start depreciating a few weeks ago; it had, in fact, steadily lost value since February 2004, long before oil prices were an issue. The monetary base was too large in February 2004, Farris explained, and the government subsequently allowed it to grow too quickly. As a result, Indonesia's inflation rate was well above the global trend, and rising. While the removal of fuel subsidies will help mitigate the government's debt-sustainability problem, it will not have a major impact on inflation or the currency, Farris concluded.

¶4. (SBU) Farris stressed that the solution to Indonesia's economic woes was "simple": the government must raise interest rates significantly. The central bank was expected to move by about 25 basis points in October if other global central banks raise rates, but that would not be enough, explained Farris. He argued that Bank Indonesia (BI) would need to ratchet monetary growth down to at most eight percent, and preferably five percent, if it were to rein in inflation to a reasonable, more sustainable level. Failure to do so would have serious implications for the country's investment strategy. Currently, Indonesia's real interest rates are close to zero, and bond yields are not far above those in the United States, he said. Under these circumstances, what incentive did investors have to hold Indonesian risk, he asked. Piron agreed, noting that smart investors were staying away from Indonesian debt.

¶5. (SBU) Farris held out little hope that this path would be followed, in large part because the Indonesian government did not believe that its loose monetary policy was flawed. "The wrong people" are running BI, he observed, and they have refused to significantly tighten monetary policy out of fear that they would deal a body blow to Indonesia's wobbling demand-led growth. BI failed to understand that its job was not to manufacture growth by expanding the money supply, but rather to foster a stable monetary environment conducive to investment, Farris said. Paracuelles agreed, citing the lack of a political consensus among the leadership for any dramatic changes in policy direction. He noted that Vice President Yusuf Kalla was an especially strong supporter of continued loose monetary policy. Kalla had also advocated stronger action on fuel subsidies -- arguing that they should be completely removed in October instead of gradually reduced as the government now intends to do -- possibly as a way of alleviating some of the pressure to raise interest rates, Paracuelles said.